

**GOVERNMENT OF THE DISTRICT OF COLUMBIA**  
**Office of the Chief Financial Officer**



Office of Integrity and Oversight

**MEMORANDUM**

**TO:** Stephen M. Cordi, Deputy Chief Financial Officer  
Office of Tax and Revenue

**FROM:** William J. DiVello, Executive Director  
Office of Integrity and Oversight *W. J. DiVello*

**DATE:** November 8, 2010

**SUBJECT:** Final Report: Audit of the Office of Tax and Revenue Audit Division's Process  
for Selecting Tax Returns for Examination and Audit (**Report No.: OIO-10-1-02-OTR**)

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This final report summarizes the results of the Office of Integrity and Oversight's (OIO's) Audit of the Office of Tax and Revenue Audit Division's Process for Selecting Tax Returns for Examination and Audit. OIO included this audit as part of its continuous audit coverage for the Office of Tax and Revenue (OTR).

This report contains three findings detailing the conditions identified during the audit. We found that the Audit Division lacks essential practices for the development of risk assessment strategies for the evaluation of tax types, and for the selection and inclusion of high risk tax types in the annual audit plan. Additionally, the Audit Division did not have the necessary policies, procedures, practices and supervisory reviews in place to ensure compliance with their own policies and relevant professional audit standards. Finally, OIO identified opportunities for the improvement in the systems and practices for the capturing and reporting of labor distribution data and levels of effort for individual examinations and audits.

OIO made 17 recommendations to address the findings cited in the report, which if implemented, should improve the operations of the Audit Division, strengthen the internal controls, and potentially increase the assessments from audits and examinations by \$8.3 million.

OTR generally agreed with our recommendations, however, some of the planned actions were not fully responsive to the recommendations, and in some instances did not provide projected completion dates for the implementation of the recommendation. The following table provides a summary of the status of the recommendations.

<b>Recommendation Status / Recommendation No.</b>	<b>Responsive to the Recommendation</b>	<b>Not Fully Responsive to Recommendation</b>	<b>Completion Date Needed</b>
	1, 3, 4, 10, and 11	5, 7, and 9	2, 6, 8, 12, 13, 14, 15, 16, and 17

OIO requests that OTR reconsider and revise its responses relative to recommendations 5, 7, and 9 and provide us with planned completion dates by November 22, 2010.

We appreciate the assistance and cooperation that you and your staff provided to OIO during this audit. Should you have questions on this report or need additional information, please contact me at 442-6433 or your staff may contact Mohamad K. Yusuff, Director, Internal Audit, at 442-8240 or Tisha N. Edwards, Senior Audit Manager, at 442-6446.

Attachment

cc: Natwar M. Gandhi, Chief Financial Officer, Government of the District of Columbia  
Angell Jacobs, Chief of Staff, OCFO  
Kathy Crader, Chief Risk Officer, OCFO  
Glen Groff, Director of Operations, OTR

**GOVERNMENT OF THE DISTRICT OF COLUMBIA  
OFFICE OF THE CHIEF FINANCIAL OFFICER**

**AUDIT OF THE OFFICE OF TAX AND  
REVENUE AUDIT DIVISION'S PROCESS  
FOR SELECTING TAX RETURNS FOR  
EXAMINATION AND AUDIT**

**OFFICE OF INTEGRITY AND OVERSIGHT**



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**AUDIT OF THE OFFICE OF TAX AND REVENUE AUDIT DIVISION'S  
PROCESS FOR SELECTING TAX RETURNS  
FOR EXAMINATION AND AUDIT**

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**AUDIT OF THE OFFICE OF TAX AND REVENUE AUDIT DIVISION'S  
PROCESS FOR SELECTING TAX RETURNS  
FOR EXAMINATION AND AUDIT**

**ACRONYMS**

AICPA	American Institute of Certified Public Accountants
CPA	Certified Public Accountant
CA	Compliance Administration
CAFR	Comprehensive Annual Financial Report
CD	Collections Division
CID	Criminal Investigations Division
<i>Code of Conduct</i>	Office of the Chief Financial Officer – Code of Conduct
DCFO	Deputy Chief Financial Officer
EQMS	Examination Quality Management Standards – Audit Standards
FY	Fiscal year
GAAS	Generally accepted auditing standards
GAGAS	Generally accepted government auditing standards
GAO	Government Accountability Office
ITS	Integrated tax system
IRS	Internal Revenue Service
<i>IA Standards</i>	<i>International Standards for the Professional Practice of Internal Auditing</i>
OGC	Office of the General Counsel
OIO	Office of Integrity and Oversight
OTR	Office of Tax and Revenue
R&C	Review and Conference Unit
TIGTA	Treasury Inspector General for Tax Administration
TSG	Tax Support Group
<i>Yellow Book</i>	<i>Government Auditing Standards – 2007 Revision</i>

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## EXECUTIVE SUMMARY

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### OVERVIEW

The Office of Integrity and Oversight (OIO) completed its audit of the Office of Tax and Revenue Compliance Administration's Audit Division's process for selecting tax returns for examination and audit. We also evaluated the process to determine whether the Audit Division maintains effective systems of internal control for the identification, selection, and examination or audit of the universe of non-real property tax returns submitted to the Office of Tax and Revenue (OTR). This audit was conducted based on the review of OTR's systems of internal controls conducted by the Treasury Inspector General for Tax Administration (TIGTA). The identification and selection of tax returns for examination and audit had been identified as a high risk area.

### CONCLUSIONS

The audit disclosed that the Audit Division lacks essential practices to ensure that all of the tax types are evaluated, using risk assessment techniques, for inclusion in its annual audit plan. The annual audit plan outlines the audit coverage and types of examinations and audits that will be performed during the fiscal year. The Audit Division could not assure itself or OTR management that all tax types would be included in the audit plan or identified as a low or medium risk that did not require coverage during the audit plan period. Referrals requesting that a specific taxpayer's return(s) be audited were not well documented relative to disposition and the process of selecting an auditor to examine or audit the return did not ensure the independence of the auditor or the Audit Division.

The Audit Division did not have the necessary policies, procedures, practices and supervisory reviews to ensure that the Audit Division's examinations and audits complied with its own policies in addition to the relevant professional auditing standards. OIO identified several significant deficiencies in the documentation of examinations and audits. These deficiencies included the absence of documentation related to the auditor's independence, audit files and workpapers that did not meet the Audit Division's current policies or the standards used by the Internal Revenue Service (IRS), the attestation standards of the Government Accountability Office (GAO) and the American Institute of Certified Public Accountants (AICPA)<sup>1</sup>. Further, the Audit Division did not have an effective process to ensure that its workpapers were adequately safeguarded, and that the files, workpapers, and supporting documentation could be retrieved intact.

Additionally, OIO identified that improvements were needed in the systems used by individual auditors to capture and report labor distribution and levels of effort on individual examinations and audits. We identified that all the staff did not report their labor distribution and levels of effort monthly, that labor distribution reports did not always have the same information carried forward, and reports were not always mathematically accurate. Further, the hours reported by

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<sup>1</sup> Section 6.01 (page 98) of *Government Auditing Standards – 2007 Revision (Yellow Book)* incorporates the AICPA's attestation engagement standards and the related Statements on Standards for Attestation Engagements into the generally accepted government auditing standards (GAGAS).

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## EXECUTIVE SUMMARY

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some auditors did not agree with their tours of duty. The labor distribution and effort reports are used to support the data included in the monthly Audit Division's Metrics Report provided to the Compliance Administration (CA) and OTR management.

As a result of the deficiencies noted in the selection of returns for examination and audit, we concluded that the Audit Division did not: (1) effectively examine or audit high risk tax returns, (2) select returns of sufficient quality to commit Audit Division resources to their examination or audit, and (3) adequately support the results of the examination or audit to comply with the Audit Division's policies, professional standards, or meet potential challenges in administrative hearings and litigation. Moreover, OIO conservatively estimates that by increasing the average assessment on closed audits and examinations through the reduction of "no change audits," increasing the scoring sensitivity, and increased audit quality in the returns selected for audit, the OTR could potentially yield a projected \$8.3 million in additional tax assessments.

### SUMMARY OF RECOMMENDATIONS AND MANAGEMENT ACTIONS

OIO directed 17 recommendations to the Deputy Chief Financial Officer (DCFO), OTR for action to correct the deficiencies described in this report. The recommendations, in part, center on:

- Development of an annual risk assessment for the complete universe of non-real property tax returns received by OTR.
- Development of annual audit plans focusing on examinations and audits of both revenue producing and high risk tax types.
- Establishment of comprehensive policies, procedures, and practices, which comply with professional standards, for the Audit Division's daily operations and its examinations and audits of tax returns including preparation of audit reports, workpapers, and supporting audit evidence.
- Modification of the integrated tax system (ITS) routines for the selection of individual returns to allow for the return's review by an experienced auditor prior to its assignment to an auditor for action.
- Development of a standardized labor distribution and effort reporting system for all Audit Division staff and activities that includes error checks and certification of accuracy by the auditor and their immediate supervisor.

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## EXECUTIVE SUMMARY

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### MANAGEMENT RESPONSES AND OIO COMMENTS

On September 30, 2010, the DCFO, OTR provided OIO with a response to the draft version of this report. The DCFO stated that OTR generally concurred with the 17 recommendations in the report. The full text of the DCFO's response is included as Exhibit D to this report.

While OTR agreed with recommendations 5, 7, and 9, the planned corrective actions do not meet the intent of the recommendations. We consider these recommendations to be partially resolved, and request that the DCFO reconsider the OTR response and provide us with additional information on the planned implementation of these recommendations. Additionally, the responses to recommendations 2, 5, 6, 7, and 12 through 17 do not include the planned completion date for the corrective actions. We request that the DCFO provide us with planned completion dates for the balance of the recommendations by November 22, 2010.



## INTRODUCTION

### BACKGROUND

The OTR is responsible for the cost effective and efficient receipt, recording, accounting, and reporting of all tax revenues and certain other revenues received by the District Government. OTR's Compliance Administration (CA) acts as the primary enforcement official for the District Government's tax laws. CA's functions include: (1) ensuring both District residents and non-resident taxpayers comply with the District's tax laws, (2) collection of delinquent and unpaid taxes, (3) verifying that resident and non-resident taxpayers have complied with the tax laws and correctly computed any tax liability and filed the necessary returns and supporting documentation. In order to carry out these functions, CA is organized into three divisions: Audit, Collections (CD), and Criminal Investigations (CID). This audit focuses on the Audit Division's process used to identify and select tax returns for examination or audit, and whether the Audit Division complies with its own policies and relevant professional standards in conducting the examinations and audits.

The CA, as the primary administrator of the District Government's tax laws, strives to encourage both residents and non-residents, conducting taxable activities within the District of Columbia, to achieve a high degree of voluntary compliance in the reporting of District taxable income and payment of taxes related to that income. CA communicates the tax laws, requirements, and changes to those laws to the taxpayers; assesses the degree of non-compliance with the tax laws; and takes a variety of actions to bring the taxpayers into compliance with the tax laws. These actions include the examination and audit of tax returns that can be limited to a specific line of the tax return, a single tax return, or multiple tax returns covering a single or multiple reporting periods. The examinations and audits can result in referrals to CD for the collection of additional taxes and to CID for potential criminal actions to enforce the tax laws and collection of the taxes owed to the District Government.

The Audit Division's responsibility included the examination and audit of 16 different tax return types. Table 1 provides a list of these return types:

**Table 1**  
**District Government Tax Return Types**

Return Type	Return Type
Individual Income, including joint return	Hotel Occupancy Tax
Inheritance and Estate Tax	Wholesalers Alcohol Beverage Tax
Fiduciary Tax	Motor Fuel Tax
Sales and Use	Toll Communication Service Tax
Unincorporated Business Franchise Tax	Commercial Mobile Service Tax
Corporate Business Franchise Tax	Gross Receipts Tax
Partnership Tax	Cigarette Tax
Employee Withholding Taxes	Personal Property

**Source:** Office of the Chief Financial Officer, OTR public webpage at:  
<http://otr.cfo.dc.gov/otr/cwp/view,a,1329,q,640958.asp>

## INTRODUCTION

Further, the Audit Division supports other CA and OTR operations by:

- Providing comments to the OTR's Office of the General Counsel (OGC) on proposed District Government statutes and regulations that may impact the tax statutes, regulations, tax returns, or the potential tax liabilities of resident and non-resident taxpayers.
- Providing comments to OGC on the impact of changes in Federal tax statutes and regulations and the potential impact of the changes on the District Government's tax statutes, regulations, returns, and potential tax liabilities.
- Holding informal administrative conferences to attempt resolution of issues raised during an examination or audit on which the taxpayer disagrees. These conferences are conducted by the Review and Conference Unit (R&C). The auditor, conducting the examination or audit, and the taxpayer or the taxpayer's representative participates in the conference.
- Assisting other CA divisions and OTR administrations by providing annual training to tax practitioners on the District Government's tax laws, regulations and filing requirements.
- Providing litigation support to the OGC staff and the Office of the Attorney General in prosecution of tax matters before the Office of Administrative Hearings and the District of Columbia Superior Court. The auditor conducting the examination or audit may testify in these proceedings.

The examination or audit of tax returns is one of the enforcement tools used by OTR and CA to enforce compliance with the District Government's tax laws. An examination or audit may result in an additional assessment of taxes, resulting in revenue, that may not have been available to the District Government had the tax return stood as filed. In some instances, the examination and audit process is time and labor intensive. Auditors are often involved in multiple examinations and audits that are in various stages of completion. Table 2 provides an overview of the number of returns filed and audited during the period October 1, 2005 through May 31, 2009 and compares it with the number of returns filed and provides the total collections for the period recorded in the Comprehensive Annual Financial Reports (CAFRs).

**Table 2**  
**Returns Filed and Audited for FY-06 through FY-09**

	<b>FY-06</b>	<b>FY-07</b>	<b>FY-08</b>	<b>FY-09 (through May 31)</b>
Number of Returns Filed	361,790	359,646	323,621	Not Available
Number Examined or Audited	3,071	4,356	7,229	5,539
Percentage Examined or Audited	0.85	1.21	2.23	Not Available
Examinations or Audits Compared to Returns Filed	1 of 118	1 of 83	1 of 45	Not Available
Total Non-Real Property Tax Collections (per CAFR)	3,231,363,000	3,594,107,000	3,574,027,000	3,107,964,000 <sup>a</sup>

**Source:** ITS data supplied by OTR's Tax Support Group (TSG); CAFRs for FY-06, FY-07, FY-08; FY-09, and Monthly Metrics Reports provided by the Audit Division.

<sup>a</sup> Amount shown is for the complete fiscal year and became available during the audit's fieldwork.

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## INTRODUCTION

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Tables B-1 through B-4 (at Exhibit B) provide, on the a fiscal year (FY) basis, details on the tax types examined or audit and the assessments levied from the audits and examinations. Table B-5 (at Exhibit B) provides data on year to year changes on the number of closed examinations and audits together with the changes in the amounts assessed during the audit period.

### OBJECTIVES, SCOPE AND METHODOLOGY

This audit was designed to determine whether: (1) the Audit Division efficiently selected tax returns for examination and audit; and (2) effective systems of internal control existed for the processes used to identify and select returns for examinations and audits. This audit's specific objectives were to:

- Determine that examinations and audits are initiated only for business purposes.
- Verify that the returns selected have a reasonable level of quality for the Audit Division to obtain the maximum return possible on its investment of resources.
- Verify that the examinations and audits comply with the Audit Division's policies and procedures and relevant professional auditing standards.

To accomplish these objectives, OIO performed a series of steps to gain an understanding of the processes and procedures employed by the Audit Division and the types of tax returns that were subject to examination or audit. Some of the steps included reviewing the public websites of the District of Columbia Auditor, the District of Columbia Inspector General, TIGTA, and the GAO for prior reports that related to the audit's objectives. The relevant portions of the public reports that we located were used to assist us in planning this audit and to assist in the evaluation of our findings. Additionally, OIO conducted interviews with the Audit Division's supervisors and managers to obtain an understanding of the operations. We reviewed the existing policies and procedures that the Audit Division provided to the TIGTA staff during its review of OTR's system of internal control.

We reviewed the Audit Division's policies and procedures for the preparation of examination and audit reports, workpapers, and audit evidence used to support the examination or audit results. Further, OIO reviewed data on the number of tax returns, including amended returns, filed in ITS from the Tax Support Group (TSG) and obtained the number of examinations and audits reported as closed by the Audit Division during the period October 1, 2005 through May 31, 2009.

To verify that the examinations and audits were appropriately selected, of reasonable quality, and complied with policies, procedures, and standards OIO selected a random sample of 100 examinations and audits<sup>2</sup> closed during the period January 1, through June 30, 2008. OIO selected the audits and examinations based on the data included in the monthly closed case

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<sup>2</sup> The actual number of examinations and audits received was 96. OIO was able to evaluate 95 of those examinations and audits. Audit was unable to locate four of the selected examinations and audits. One return that was reported as closed was not an examination or audit, according to a supervisory auditor, but an auditor reporting that an out-of-state business had filed a specific type of return.

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## INTRODUCTION

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reports provided to the Audit Division's management. We obtained the relevant audit files consisting of audit reports, files, workpapers and supporting documentation and evidence for our sampled returns. OIO evaluated the audit files using the Audit Division's policies and procedures, the IRS' Examination Quality Management System – Auditing Standards (EQMS), and the attestation standards of GAO and the AICPA.

The audit includes the period October 1, 2005 through May 31, 2009. Our work was done in accordance with generally accepted government auditing standards for performance audits. Those standards require that we plan and perform the audit to obtain sufficient appropriate evidence to provide a reasonable basis for our findings and recommendations based on our audit objectives. We believe that the evidence we obtained provides a reasonable basis for our findings, and recommendations.

OIO used computer processed data from ITS to assist us in obtaining background information and the number of tax returns filed in ITS. However, we did not rely on this data to support the report's findings and recommendations. Therefore, we did not perform a reliability assessment of the computer processed data.

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## FINDINGS AND RECOMMENDATIONS

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<b>FINDING 1:</b>	<b>METHODOLOGY AND SELECTION PROCESS FOR EXAMINATIONS AND AUDITS</b>
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### SYNOPSIS

The process employed by the Audit Division to select returns for examinations does not ensure that a broad range of tax types will be selected for examination or audit. The majority of the returns examined or audited during the audit period came from four categories: individual returns, Federal adjustments, excise taxes, and sales and use taxes. These four categories comprised 88.48 percent of all returns audited or examined and 70.01 percent of the amount of additional tax assessments during the period October 1, 2005 through May 31, 2009.

Of the 16 tax types listed on the Audit Division's webpage, nine tax types were reported, in the Monthly Metrics Report, to have had more than one examination or audit completed during our audit period. OIO found that the absence of coverage of the other 7 tax types could be attributed to several deficiencies:

- Absence of an effective risk assessment methodology for all non-real property tax return types;
- Absence of a risk based annual audit plan that addresses high risk return types;
- Disabling of the automated selection process for examinations and audits of individual returns;
- Lack of experienced auditors screening returns selected for examination or audit for quality prior to assignment to an auditor; and
- Use of a self-selection process for certain business type returns referred for possible examination or audit.

As a result of these deficiencies, the Audit Division may not be selecting and auditing the highest risk types, maximizing the amount of taxes assessed by return type, and may be committing resources to examinations and audits that over time will have diminished results relative to a return on investment of audit resources. Moreover, OIO conservatively estimates that by increasing the average assessment on closed audits and examinations through the reduction of "no change audits," increasing the scoring sensitivity, and increased audit quality in the returns selected for audit, the OTR could potentially yield a projected \$8.3 million in additional tax assessments.

### DISCUSSION

Table 3 provides a summary of the number of examinations and audits reported as closed during the audit period. Further, it provides the total assessments for the reported tax types.

## FINDINGS AND RECOMMENDATIONS

**Table 3**  
**Summary of Examinations, Audits and Assessments**  
**FY-06 through FY-09 (May 31)**

Return Type	Examined or Audited		Additional Assessments	
	Number	Percentage <sup>1</sup>	Amount	Percentage <sup>1</sup>
Individual Income Tax (includes joint returns)	7,559	37.43	46,881,455	21.24
Corporate Franchise	1,027	5.09	38,738,537	17.55
Unincorporated Franchise	329	1.63	9,393,799	4.26
Fiduciary	19	0.09	345,665	0.16
Withholding	141	0.70	493,420	0.22
Sales and Use	1,404	6.95	64,967,090	29.43
Excise Tax	1,494	7.40	21,181,520	9.60
Inheritance and Estate	149	0.74	7,897,297	3.58
Personal Property	659	3.26	8,117,459	3.68
Federal Adjustments	7,412	36.70	21,509,304	9.74
CP-2000	0	0.00	0	0.00
Multistate	2	0.01	1,222,256	0.55
Hotel Occupancy	0	0.00	0	0.00
<b>Total</b>	<b>20,195</b>	<b>100.00</b>	<b>220,747,802</b>	<b>100.00</b>

**Source:** Monthly Metrics Reports provided by the Audit Division

<sup>1</sup> May not total due to rounding

a. Absence of Effective Risk Assessment Methodologies and Risk Based Audit Plan

The Audit Division is responsible for the examinations and audits involving 16 tax types; however, they do not have in place an effective risk assessment that annually reviews each tax type and assesses the risk involved with each. According to the Audit Division's staff, they focus on the tax types that provide the greatest opportunity for assessment of additional taxes and those are the areas concentrated on. This process is based on years of experience with the District Government's tax systems and staff experience. Further, the audit plan is driven by the amount of revenues included in the annual operating budget for additional tax assessments. According to responsible personnel, because of these two factors, an audit plan based on a risk assessment approach is not necessary.

Developing a risk assessment methodology and then applying it to the universe of tax return types is a sound business practice. A risk assessment methodology allows management and staff to update their knowledge of the tax types and any significant changes that have occurred that may impact the accurate filing of tax returns. Also, it allows the Audit Division to highlight to OTR management tax return types that are of concern. Further, the use of a risk assessment methodology may highlight areas where additional tax assessments are possible, due to filing issues and non-compliance. Lastly, a risk assessment process would allow the Audit Division to methodically focus on areas of perceived risk and to test those areas by devoting a limited amount of resources.

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## FINDINGS AND RECOMMENDATIONS

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b. Audit Does Not Consider the Complete Universe of Tax Types from which to Select Returns

The Audit Division does not consider all of the tax return types filed with OTR when selecting returns for examination and audit. Examinations are generally limited to the return types filed using ITS. Table B-6 (at Exhibit B) provides detailed information on the returns that are processed directly through ITS and those returns that are accounted for in Excel, Access, or FoxPro databases.

The practice of not periodically conducting examinations and audits of all tax return types adversely impacts OTR's ability to assure that taxpayers file appropriate and accurate tax returns. Periodic selection of non-ITS return types would provide added veracity and accuracy of the tax returns filed.

The current metrics reporting practices further impacts the perception that only ITS return types receive extensive audit coverage. Of the specific tax types included in the monthly metrics reports the only non-ITS returns reported are multistate and estate and inheritance tax returns (see Tables B-1 through B-4 at Exhibit B). Our interviews and review of the Audit Division's labor distribution reporting found that other returns were audited; however, they were not included in the Monthly Metrics Report which understates the number of examinations and audits closed and the amount of the additional assessments levied. For example, our review of the monthly labor distribution reports found that one auditor consistently charged time to cigarette tax examinations and audits. However, none of these audits were reported as closed or the assessments, if any, reported.

The use of a risk based annual audit plan provides several benefits to the Audit Division and the CA and OTR management. First, the plan provides a prioritized series of examinations and audits based on a risk evaluation of all the auditable tax types. Second, it provides a proposed allocation of resources to meet the requirements of the plan. Finally, the annual plan provides a tool for CA and OTR management to help assess the effectiveness of the Audit Division and the employment of the available resources to accomplish the annual plan. The annual plan can provide a methodology for addressing taxpayers and returns that have been referred for an examination or audit.

The OIO employed a portion of the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing (IA Standards)* as an illustration of a best practice for the development and presentation of annual audit plan and the needs for periodic updates of the plan during the fiscal year based on updated risk assessments and the needs of OTR and OCFO management. The standard is presented below and additional information is provided in C-1 (Exhibit C).

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## FINDINGS AND RECOMMENDATIONS

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*IA Standards* discuss the need for an audit plan by stating in section 2010, *Planning*, that:

*"The chief audit executive<sup>3</sup> must establish risk-based audit plans to determine the priorities of the internal audit activity consistent with the organization's goals.*

*Interpretation:*

*The chief audit executive is responsible for the development of a risk based audit plan. The chief audit executive takes into account the organization's risk management framework, including risk appetite levels by management for the different activities or parts of the organization. If a framework does not exist, the chief audit executive uses his/her own judgment of the risks after consultation with senior management and the board."*

c. Automated Selection Process for Individual Income Tax Examinations and Audits Disabled.

In order to provide a review of the large number of individual income tax returns received by OTR, ITS is employed to initially review and screen the returns for both mathematical errors and to determine if the return warrants additional reviews by Audit Division's staff. The returns are randomly assigned to specific auditors by ITS.

ITS selects tax returns for examination or audit based on an automated scoring methodology. The methodology compares the amounts entered on specific lines of the return with pre-established values and standards. The complete return is scored and those returns with score that equals or exceeds a specific amount are automatically selected for examination or audit and randomly assigned to an auditor.

These pre-established amounts as well as the score triggering the return's selection are set by the Audit Division and entered into ITS by the TSG staff. The pre-established values and the selection score can be altered by the Audit Division and TSG. By increasing the pre-established values for specific lines and raising the selection score; the Audit Division has the potential to significantly reduce the number of returns selected for examination or audit.

However, the automated selection process for individual income tax returns, according to a supervisory auditor, was disabled in approximately March 2009, due, in part; to the number of returns assigned to the audit staff overwhelmed the staff's ability to conduct examinations and audits. The return selection process did not consider the auditors' workloads or experience levels when assigning returns for examination or audit. According to the Audit Division staff, the computer selected returns were not always considered a priority and could remain in the auditor's queue for an extended period of time.

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<sup>3</sup> For the purpose of this audit, OIO considers that the Chief, Audit Division to be the chief audit executive when referring to *IA Standards*



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## FINDINGS AND RECOMMENDATIONS

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### d. Audit Did Not Use Experienced Auditors to Screen ITS Selected Tax Returns

The Audit Division did not effectively employ experienced auditors to screen ITS selected returns before the return is assigned for examination or audit. The absence of a screening process resulted in increased numbers of “no change” examinations and audits. Table B-5 (at Exhibit B) shows that the number of examinations and audits closed by the Audit Division increased from 3,071 in FY06 to a projected 8,083 in FY09, an increase of 263.20 percent. However, the average additional assessment has decreased from \$11,251 per return in FY06 to \$8,144 at the close of FY09; a decrease of 27.62 percent over the same period. These changes indicate that while the number of closed examinations and audits increases the additional assessments are decreasing in part to a significant number of “no change” audits. The Audit Division’s supervisory auditors that we interviewed confirmed this. One stated that there was little that could be done to change this pattern without changing the ITS selection program.

OIO conservatively estimates that by increasing the average assessment on closed audits and examinations from \$8,144 to \$8,921<sup>4</sup> through the reduction of “no change audits”, increasing the scoring sensitivity, and increased audit quality in the returns selected for audit, the OIR could potentially yield a projected \$8.3 million in additional tax assessments.

The use of computerized scoring of tax returns is to assist the Audit Division in identifying returns that are outside of specific criteria. This process is both fast and efficient as ITS performs the necessary reviews and calculations as part of its initial review of the return. However, this process has several drawbacks that result in more returns than necessary assigned to auditors for examination and review. The current system is unable to holistically assess the return, determine whether the same issues was raised in prior years and the resolution of that issue, and to determine if the data on the return makes economic sense. It cannot review prior returns, audits and reviews to determine whether (1) the issue was raised in prior years, (2) whether the data makes economic sense, (3) the prior examinations and review results, and (4) whether any additional amounts were assessed to the taxpayer. Nor can the system assess the return’s audit quality. For example, an individual who has very high deductible expenses compared to income; the section routine cannot determine that the expenses are similar to the prior years and that the individual for some period during the year received unemployment benefits or retired.

Screening of the ITS selected returns, by an experienced auditor, helps to ensure that the Audit Division is identifying the returns that have the highest probability of producing additional assessments. Screening has the potential for the Audit Division to reduce the number of returns that result in “no change” examinations and audits by identifying returns where: (1) the selection was based on the same issues decided in prior years, and (2) additional documentation filed with the return provides evidence to support the amount(s). Screening a return, using an experienced auditor, provides a more thorough review of the document and could result in the identification

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<sup>4</sup> This amount represents an increase of 25 percent of the difference between the FY-06 average assessment of \$11,251 and the actual FY-09 average assessment of 8,144 or \$3,107.

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## FINDINGS AND RECOMMENDATIONS

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of other issues or higher return on investment of resources and potentially other tax returns to include in an examination or audit.

e. Auditor Selection for Business Returns that are Referred is Essentially Self-Selection.

The Audit Division's process for accepting referrals of specific taxpayers or a specific return for an examination or audit is essentially a self-selection process. An auditor making a referral of a taxpayer or return has a high probability of examining or auditing the same return. The process does not provide the necessary assurance that: (1) the auditor is independent; (2) the return was selected for a valid business purpose; (3) the taxpayer is protected from actual or perceived harassment by the Audit staff.

The Audit Division each year completes examinations and audits on a number of returns that have been referred from sources outside the office selection process. Although nothing came to our attention in our audit of a sample of closed examinations and audits that caused us to believe that the returns were not selected for a valid business purpose; OIO found that the Audit Division does not maintain a process that assures objectivity and auditor independence, and the process for the justification to select the return is documented. Further, the absence of documentation in the audit files supporting the selection of a specific taxpayer and returns does not preclude the situation where the taxpayer or return may have been self-selected. Responsible personnel stated that the Audit Division adhered to the following process for taxpayers and returns that have been referred.

- a. The auditor conducts limited preliminary research on the taxpayer and returns using only "in-house" data and determines whether additional work is warranted.
- b. If the work is warranted, the auditor sends the data to their immediate supervisor for review and concurrence/rejection
- c. If the supervisor concurs the data is forwarded on to R&C for review and concurrence. Should the supervisor reject the data the auditor is informed.
- d. Should R&C not concur, all data gathering on the taxpayer or return is to stop and the auditor is informed of the rejection.
- e. Based on R&C's approval of the project a specific case number is assigned and the examination or audit is assigned to a specific audit unit. Generally the unit is the one making the referral.
- f. The unit supervisor selects the auditor to perform the examination or audit, again generally the individual who made the referral.
- g. The formal announcement of the audit is made and the supervisor and R&C are responsible for tracking the progress of the audit.

In the files that we examined we found no documentation that would support this process. Further, OIO's interviews revealed that few if any of these referrals would be rejected by either the supervisor or R&C.

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## FINDINGS AND RECOMMENDATIONS

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### RECOMMENDATIONS

OIO recommends that the Deputy Chief Financial Officer, OTR take the following actions:

1. Develop annual risk assessments and methodologies for all non real property tax returns that incorporate the prior year audit results and significant changes in the statutes and regulations.
2. Incorporate the *IA Standards for Planning*, or similar guidance into the annual planning process.
3. Develop an annual risk based audit plan that incorporates estimates of staff availability and risk assessments.
4. Revise the Monthly Metrics Report to include all tax return types and reflect the data in the annual plan.
5. Modify the ITS selection criteria to increase the sensitivity to the items selected and the score that must be obtained for selection as a potential examination or audit.
6. Use experienced auditors to screen returns selected for examination and audit prior to assignment to another auditor decreasing the number of “no change returns” and increasing the audit quality of the returns and the potential additional tax assessments. The reason for rejection of any selected returns should be documented.
7. Revise the process for review and assignment of taxpayer and return referrals to ensure independence in the referral/audit process. For example requiring all the auditors involved in the planning, execution, or review of the audit to sign an independence statement. The independence statement includes both the *Code of Conduct* and GAGAS requirements.

### MANAGEMENT RESPONSES AND OIO COMMENTS

#### Management Response (Recommendation 1)

The DCFO agreed with the recommendation and plans to develop a return classification program that will include critical aspects of a risk assessment program for the selection of tax return types for examination and audit; using the guidelines and selection methodologies developed by the IRS. OTR expects that the return classification program will be in place by September 30, 2011.

#### OIO COMMENT

We consider OTR’s planned actions to be responsive to our recommendation.

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## FINDINGS AND RECOMMENDATIONS

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### **Management Response (Recommendation 2)**

The DCFO agreed with the recommendation. The CA staff will use the IRS' standards and guidance to plan the types of tax returns to be examined or audited annually by the Audit Division. The IRS standards and guidance provides a better alignment to the types of examinations and audits conducted by the Audit Division.

### **OIO COMMENT**

We consider OTR's planned actions to be responsive to the intent of the recommendation. We request that OTR provide the planned completion date for these corrective actions to us by November 22, 2010.

### **Management Response (Recommendation 3)**

OTR agrees with the recommendation, responding that the annual audit plan would be incorporated into the annual Return Classification and Audit Work Plan that is under development as part of Recommendation 1. OTR expects that the Return Classification and Audit Work Plan will be completed by September 30, 2011.

### **OIO COMMENT**

We consider OTR's planned actions to be responsive to the intent of the recommendation.

### **Management Response (Recommendation 4)**

OTR agreed with the recommendation to update the Metrics Report to include all of the return types except for the CP-2000 program, managed by the Collections Division, and the Hotel Occupancy Tax which will not be included in the Return Classification and Audit Work Plan (see Exhibit D). The updated Metrics Report is expected to be completed by December 31, 2010.

### **OIO COMMENT**

We consider OTR's planned actions to be responsive to the intent of the recommendation.

### **Management Response (Recommendation 5)**

The DCFO agreed with the recommendation. The response indicates that the Classification Process will establish an ongoing pool of cases for examination and audit. The pool of cases will be controlled by R&C. R&C will provide a selection of cases to each Audit Division manager as they request them. This will eliminate the need for individual audit teams to hold large inventories of unassigned cases.

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The response further stated that the Audit Division would request that the TSG make the changes to the sensitivity settings for the scoring and selection of individual returns for examination and audit.

### OIO COMMENT

The response provided by OTR agrees with the recommendation but the planned actions do not meet the intent of the recommendation. This recommendation focuses on changing the elements of the scoring and selection process to reduce the number of returns selected for potential examination and audit. The classification process described in OTR's response could become overwhelmed by the number of returns selected using the current methodologies and scoring methods. A manual selection process for these returns is unrealistic due to the volume of the returns. Adjusting the sensitivity of the scoring process could reduce the number of returns selected and provide a higher quality of return at the same time for examination or audit. OIO requests that OTR reconsider its response and provide us with a revised response and target completion date for completion of the corrective actions by November 22, 2010.

### Management Response (Recommendation 6)

The DCFO concurred with the recommendation and stated that senior tax auditors would participate in the return classification process on a rotational basis.

### OIO COMMENT

We consider OTR's planned actions to be responsive to our recommendation; however OTR did not provide a target date when the corrective actions are expected to be completed. We request that the DCFO provide us with planned completion date for this recommendation by November 22, 2010.

### Management Response (Recommendation 7)

The DCFO concurred with the recommendation to revise the tax return referral process. However, OTR did not agree that the auditors involved in the planning, execution, or review of the referred return's examination complete an independence statement.

### OIO COMMENT

While OTR agreed with our recommendation the response did not address how they would revise the referral process. OIO requests that OTR provide an outline of how it expects to revise the examination and referral process by November 22, 2010.

Additionally, OTR does not agree with our recommendation that the auditors involved in the planning, execution, and review of examinations and audits sign an independence statement that would be included in the examination or audit's workpapers. In both oral and written comments

## **FINDINGS AND RECOMMENDATIONS**

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provided to OIO, OTR indicated that they believe that the requirements of the OCFO's Code of Conduct are sufficient to address this area. OIO disagrees with this assertion. Requiring the auditors involved with examinations and audits to certify their independence reinforces the concepts of integrity and assists in ensuring that the individuals performing the examinations and audits maintain their independence. OTR should reconsider its position regarding the independence standards and certification as to compliance with those standards. Accordingly, we request OTR reconsider its position relative this recommendation.

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## FINDINGS AND RECOMMENDATIONS

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### FINDING 2: AUDIT DOCUMENTATION

#### SYNOPSIS

Our testing of a sample of closed examinations and audits found that the audit reports were not always complete; workpapers did not support the results of the audits or comply with the Audit Division's policies and procedures; and audit documentation did not adequately support data in the workpapers or the reports. The Audit Division did not have an effective quality control system to ensure that all reports, workpapers, and audit documentation were reviewed and evaluated against the Audit Division's own policies and procedures in addition to professional standards. Supervisory reviews of the reports, workpapers and audit documentation were either not effective or not done. Further, we found weaknesses in the safeguarding of audit files.

As a result, the Audit Division was unable to provide reasonable assurance that its reports and workpapers could be relied upon. For example, audit results may not be supportable in administrative hearings before the Office of Administrative Hearings or in judicial proceedings before the Superior Court.

#### DISCUSSION

##### a. Compliance with Policies, Procedures, and Professional Auditing Standards

The examination or audit of a tax return, whether specific lines or the return as a whole, must be fully documented and supportable. The taxpayer is asserting that the taxable income, deductible expenses, and amounts due and paid to the District Government are accurate, complete, and in compliance with the applicable laws and regulations. The taxpayer when they sign the return takes responsibility for these assertions. The Audit Division's responsibility is to validate the accuracy of these assertions.

Several different organizations have established auditing standards that have an impact on this audit. These organizations include the IRS Examinations Division's EQMS that addresses the audit standards followed in tax examinations and audits. The GAO's *Government Auditing Standards – 2007 Revision (Yellow Book)* which provides the generally accepted government auditing standards (GAGAS) for use by governmental auditors and auditors performing governmental engagements where GAGAS is required. Further, the AICPA provides the generally accepted auditing standards (GAAS) for non-public companies. The AICPA standards are incorporated into GAGAS by reference. Finally, the Audit Division's policies and procedures are to comply with GAGAS according to their publication *Audit Guidelines – Compliance Administration*.

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EQMS is used by the Service's Examinations Division to evaluate compliance with its standards and policies; Table B-7 (at Exhibit B) outlines these standards. According to a GAO report<sup>5</sup>

*"... the IRS Examination Division has responsibility for Quality Measurement Staff operations and the Examination Quality Measurement System (EQMS). Among other uses, IRS uses EQMS to measure the quality of closed audits against nine IRS standards. The standards address the scope, audit techniques, technical conclusions, workpaper preparation, reports, and time management of the audit..."*

GAO's *Yellow Book*<sup>6</sup> contains GAGAS for a wide range of financial audits, performance audits, and attestation engagements. The AICPA's professional auditing standards also impact financial audits and attestation engagements. GAGAS requires that the AICPA's standards be followed when performing financial audits and attestation engagements<sup>7</sup>.

GAGAS defines an attestation engagement as an examination, review, or agreed-upon procedures report on an assertion or subject matter that is the responsibility of another party (see Exhibit C-2) for the complete definition. Included in this definition is the compliance with requirements of specific laws, regulations, policies, contracts, or grants.<sup>8</sup>

GAAS uses a similar definition of attestation engagement<sup>9</sup> as the *Yellow Book* (see Exhibit C-3). The GAAS standards further state that practitioners who undertake attestation engagements for the benefit of a government body or agency and agrees to follow specified standards must follow those standards and GAAS attestation standards.

### b. Compliance with Standards Required to Maintain Professional Licenses

Our review of the closed examination and audit files found that one supervisory auditor responsible for an audit team and the R&C, who purports to be a certified public accountant (CPA), did not comply with the relevant professional standards for the planning examinations and audits and supervision of other auditors performing examinations and audits<sup>10</sup>. We found no evidence of review by immediate supervisors in 83 percent of the closed examinations and audits. Also the R&C failed to provide evidence that of review in 100 percent of the closed examinations and audits we reviewed.

Individuals holding a license as a CPA are expected, by regulations in most states and the District of Columbia, to comply with the relevant audit standards in their work, in addition to the complying with Audit's policies and procedures. A CPA who does not comply with the relevant

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<sup>5</sup> Government Accountability Office, formerly the General Accounting Office; *IRS AUDITS: Workpapers Lack Documentation of Supervisory Review*; Report Number: GAO/GGD-98-98; April 1998: page 12.

<sup>6</sup> Comptroller General of the United States; Government Accountability Office; *Government Auditing Standards – 2007 Revision*; Report Number: GAO-07-731G, July 2007.

<sup>7</sup> Ibid; §§ 4.04, 5.03, and 6.01

<sup>8</sup> Ibid; § 1.24

<sup>9</sup> American Institute of Certified Public Accountants; *Professional Standards as of June 1., 2008; Attest Engagements*; section AT 101 located at <http://www.aicpa.org/download/members/div/auditstd/AT-00101.PDF>

<sup>10</sup> Comptroller General of the United States; Government Accountability Office; *Government Auditing Standards – 2007 Revision*; Report Number: GAO-07-731G, July 2007; §§ 6.04, 6.21 and 6.22 c.



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## FINDINGS AND RECOMMENDATIONS

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professional standards is subject to disciplinary action by the state or District licensing authority and possibly suspension or termination of their license.

Title 17 section 2511.8 of the District of Columbia Municipal Regulations (see C-4 at Exhibit C) requires that individuals holding a CPA license issued by the District Government comply with the relevant professional standards for the services that they perform. This requirement is similar to that of most states.

### c. Auditor Independence

The Audit Division does not have a formalized process for the documenting that the staff is independent of the examinations and audits they conduct. Auditors were not required to document their independence at the time of the assignment to the examination or audit, and if necessary during or at the close of the examination or audit. Further, we found that the Audit Division had not developed a process in which to resolve potential and actual independence issues. Management informed us that they relied on the *Office of the Chief Financial Officer's Code of Conduct (Code of Conduct)* to ensure that the auditors are independent of the taxpayers that they examine or audit. Their expectations were that the auditors would orally advise them of any potential or actual conflicts. GAGAS goes beyond the expectations of the *Code of Conduct* to include biases and preconceived ideas that may impact the auditor's views and interactions with the taxpayer and discusses the process of seeking employment with the taxpayer during the conduct of the audit.<sup>11</sup> GAGAS generally outlines the independence standards that are expected for organizations and auditors performing engagements in compliance with GAGAS in sections 3.02 and 3.03.

Documentation of the absence of impairments or that an impairment to independence exists and how the Audit Division resolved it is critical to ensuring that the auditors and the organization are free from actual or perceived independence impairments. GAGAS states in section 3.11 that audit organizations include policies and procedures for the identification and resolution of impairments to independence as part of their quality control systems.

### d. Audit Reports, Workpapers and Documentation Do Not Meet Standards

OIO conducted a random sample of 95 examination and audit files<sup>12</sup> that were reported as closed during the period January 1 through June 30, 2008. Our testing was to determine whether policies and procedures were in place and followed to assure compliance with GAGAS and verify that the reports, workpapers, and documentation supported the additional amount of taxes assessed to the taxpayers. Table 4 provides a summary of the results of our testing.

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<sup>11</sup> Ibid §§3.07 e, f, and g.

<sup>12</sup> The original sample was 100 examination or audit files. Audit did not locate four files and one file was not considered to be an examination or audit according to a supervisory auditor. The auditor only ensured that an out-of-state corporation filed a tax return in order to obtain a "clean hands" certificate.

## FINDINGS AND RECOMMENDATIONS

**Table 4**  
**Summary of Test Results**

Item Tested	Complied	%	Did not Comply	%	Other	%
<b>Audit Report Prepared by Audit</b>						
Auditor Signed the Report	73	76.84	22	23.16	0	0
Review Signed the Report	77	81.05	18	18.95	0	0
Auditor Number was Included	30	31.58	65	68.42	0	0
Type of Tax Return Examined/Audited Included	61	64.21	30	31.58	4	4.21
Total Hours Expended on the Audit Listed	31	32.63	64	67.37	0	0
Audit Starting and Completion Dates Listed	32	33.68	55	57.89	8	8.42
Reason for the Audit Listed	29	30.53	47	49.47	19	20
Documentation Tested by the Auditor Listed	39	41.05	56	58.95	0	0
Summary of Adjustments Provided	79	83.16	14	14.74	2	2.11
Explanation for the Adjustments Provided	78	82.11	16	16.84	1	1.05
<b>Workpaper Files Supporting the Audit Report</b>						
Source of workpaper Data Included	62	65.26	33	34.74	0	0
District Tax Return Included	82	86.32	11	11.58	2	2.11
Workpapers support Audit Report conclusion	63	66.32	31	32.63	1	1.05
Evidence of Review by Supervisor	16	16.84	79	83.16	0	0
Evidence of Review & Conference Review	0	0.00	95	100.00	0	0
Completed ITS form included in the file	51	53.68	27	28.42	17	17.89

**Source:** OIO's review of selected examination and audit files.

OIO identified that significant deficiencies existed in meeting the Audit Division's own policies and procedures. OIO's review of the audit reports identified that in 23 percent of the of the files that the audit reports were not signed, 32 percent of the audit reports did not list the type of return that was examined or audited, and in excess of 50 percent did not list total time expended, start and end dates for the project or the documentation tested by the auditor.

Similar discrepancies were found in the review of the workpaper files where 83 percent had no evidence to support a review by the immediate supervisor and none of the workpapers had evidence that R&C reviewed the examination or audit for quality control. The workpapers in 33 percent of our sample did not support the conclusions in the audit report, and 35 percent did not provide the source of the data for the workpaper.

Audit files are the lynchpins in linking the audit report to the fieldwork performed during the examination, audit, and the amount of additional taxes assessed. At a minimum the workpapers should provide data on the: (1) planning of the examination or audit, (2) procedures performed, (3) evidence obtained, (4) evaluation of the evidence against applicable laws and regulations, (5) supervision of the auditor(s) involved, and (6) direct linkage to the conclusions in the report. The Audit Division did not ensure that sufficient evidence was included in the audit files to support that the report and workpapers met the minimum standards for compliance with GAGAS §§ 6.20 – 6.23.

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## FINDINGS AND RECOMMENDATIONS

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As part of our testing of closed cases, we noted in one sales tax case the taxpayer, a labor service provider, disagreed with the auditor's calculation of the amount of services and labor that must be reported and taxed. The taxpayer stated that the auditor incorrectly included invoices that included tax exempt sales and charges for labor that were not taxable according to the statute. The auditor's workpapers did not include: (1) information on the source of the invoices; (2) data on how the taxable amounts were computed; and (3) how the amount of taxable sales was resolved. Additionally, a senior auditor assigned to train the auditor on this type of sales tax audit provided no comments in the workpapers related to the computation of the taxable sales or the taxpayer's argument that the auditor computed amount was erroneous. The District Government, based on a settlement with R&C, received \$2,100 less in sales tax revenues than originally computed by the auditor.

According to the Audit Division supervisors we interviewed, the audit report form was included in each tax file. This report provides information on the type of work done the responsible auditor and evidence of supervisory review. We noted in several instances where Federal adjustments were supported only by a copy of the IRS generated document and a statement that the adjustment did not impact the DC tax return filed by the taxpayer. A number of these no change Federal adjustments were included in a single audit folder. It appeared that the work was not reviewed by the responsible supervisor prior to closing the case. One supervisor was unaware that this documentation shortcut was used by the auditors until OIO requested that specific files be provided for this review.

In two of the files, reviewed by OIO, we found that the workpapers consisted of no more than copies of the taxpayer's tax returns and some documentation that purports the auditor went to pick-up the returns and checks, that were processed through ITS, for the payment of the delinquent taxes. The auditor, in their monthly report, listed that an examination or audit of the taxpayer had been done and the case closed. OIO does not agree with this assertion by the auditor and the Audit Division for this case. Obtaining a delinquent tax return and payment is not an audit, even under the broadest terms of the definition. The absence of any workpapers to support that an examination or audit had been done places the accuracy of the reporting by the auditor and the Audit Division into question.

Our review of the audit files allowed us to conclude that the review of the auditor's work by a team supervisor and R&C was ineffective. The team supervisor did not appear to do more than initial the "audit report" in many of the audit files that we reviewed. None of the files reviewed appeared to go to R&C for a quality control review. The reviews at the supervisory and R&C levels were not sufficiently documented to allow for an experienced independent auditor to conclude that a review had been done and that the auditor "cleared any notes from the review". The supervisory and R&C reviews are critical to ensure that the audit supports the conclusions made by the auditor and that the examination or audit meets the Audit Division's internal standards in addition to the relevant professional standards.

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## FINDINGS AND RECOMMENDATIONS

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The absence of standardization of the workpapers and audit files appears to impact the negatively support of the auditor's conclusions and the work performed by the auditor. We found wide variations in the documentation of the work performed on individual examinations and audits. This wide variation does not allow the auditor to ensure that they have achieved the objectives of the examination or review, obtained sufficient and relevant data to support the conclusions of the audit report, and provided sufficient data for the supervisor or other reviewer of the audit file to conclude that the examination or audit met Audit's and the relevant professional standards.

The Acting Supervisor of R&C told us that the conditions that we found in our sample were not indicative of the current practices. He stated that the Audit Division undertook several actions based on a complaint from the OGC that Audit's documentation practices did not support the findings in a case brought to the D.C. Superior Court. The Audit Division's management reviewed several examinations and audits finding a number of deficiencies. Additionally, the Acting Supervisor of R&C stated that the Audit Division significantly increased the number of auditors during FY07 and FY08 that resulted in disparities in the methods used to document audit files. R&C provided training to the entire staff, at the end of FY08, regarding documentation and the evidence to be included in the folders. The Acting Supervisor indicated that in FY09 the conditions have significantly improved. OIO reviewed a judgmental sample of ten files for audits that were closed during FY10 and found that the documentation of the work and condition of the files had improved.

e. Safeguarding of Audit Workpapers and Files

The GAGAS §6.24 requires that policies and procedures be in place to retain and safeguard audit workpapers, the related audit documentation and audit files. The Audit Division does not have a system that assures that all audit workpapers, documentation, and files are retained and safeguarded from loss or destruction. Responsible personnel stated that adequate storage space does not exist to safeguard and secure all of the tax files. At the time of this audit, space was primarily allocated to files containing IRS supplied information that is required to be secured. Other audit files are retained by the individual auditors and their supervisors. This practice subjects the files to additional unnecessary risk of loss or destruction.

### RECOMMENDATIONS:

OIO recommends that the DCFO, OTR take the following actions:

8. Direct the development of GAGAS compliant and comprehensive policies, procedures, and practices for conducting examinations and audits.
9. Mandate documented compliance with the independence standards of the GAGAS and the Code of Conduct. For example, requiring auditors to sign an independence statement.
10. Direct specific procedures for the preparation of workpapers, indexing, and audit documentation.

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## FINDINGS AND RECOMMENDATIONS

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11. Mandate that R&C and Audit Division management develop a documented quality control system for all examinations and audits.
12. Direct that R&C, based on the results of quality control reviews, provide training on a group and individual level. Training should include the Audit Division's policies and procedures, audit standards, preparation of workpapers, audit evidence, preparation of audit reports, and quality control standards.
13. Develop a policy and system for retention of all examination and audit reports, workpapers, documentation and files in a centralized location.

### MANAGEMENT RESPONSES AND OIO COMMENTS

#### Management Response (Recommendation 8)

OTR agrees with this recommendation in part. They have agreed to develop the comprehensive policies, procedures, and practices. They do not agree that these policies, procedures, and practices should be GAGAS based. OTR's opinion is that the policies, procedures, and practices should be based on the IRS standards for audits and examinations and these standards more closely mirror the examinations and audits undertaken by the Audit Division.

#### OIO COMMENTS

We consider OTR's planned actions to be responsive to the intent of the recommendation. OTR did not provide an anticipated date for the completion of the policies, procedures, and practices. OIO requests that OTR provide an anticipated completion date by November 22, 2010.

#### Management Response (Recommendation 9)

OTR referred the reader to the previous response in which it agreed with the recommendation, in part, to document compliance with professional standards, and disagreed with the recommendation that the Audit Division comply with the standards included in GAGAS.

#### OIO COMMENTS

We consider OTR's planned actions to be partially responsive to the intent of the recommendation. Documentation of compliance with professional audit standards, whether they are the standards used by the Internal Revenue Service or GAGAS, allows the auditor to demonstrate that they have fully complied with the relevant standards and that the examination or audit is competent, objective, and independent.

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## FINDINGS AND RECOMMENDATIONS

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OTR did not provide an anticipated date for the completion and implementation of the policies, procedures, and practices. OIO requests that the anticipated completion date be provided by November 22, 2010.

### **Management Response (Recommendation 10)**

This recommendation has been implemented. The Audit Division has posted a series of standardized workpapers for various examinations and audits on the OCFO Intranet site.

### **OIO COMMENTS**

The recommendation is closed.

### **Management Response (Recommendation 11)**

The DCFO agreed with this recommendation. The Audit Division in FY-2010 implemented a post audit review process. The post audit review is conducted by the R&C, which identifies trends and patterns for training purposes. R&C has developed post audit review policies and procedures.

### **OIO COMMENTS**

The recommendation is closed.

### **Management Response (Recommendation 12)**

OTR agrees with the recommendation of using the results of the quality control reviews as a basis for providing training. The Compliance Administration will determine the individual(s) or group(s) who will conduct the training.

### **OIO COMMENTS**

We consider OTR's planned actions to be responsive to the intent of the recommendation. OTR did not provide an anticipated date for the completion of the policies, procedures, and practices. OIO requests that OTR provide an anticipated completion date by November 22, 2010.

### **Management Response (Recommendation 13)**

OTR agrees with the recommendation and has ordered eight large hard drives (one terabyte each) to hold the electronic images of the examination and audit files.

## **FINDINGS AND RECOMMENDATIONS**

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### **OIO COMMENTS**

We consider OTR's planned actions to be responsive to the intent of the recommendation. OTR did not provide an anticipated date for the completion of the policies, procedures, and practices. OIO requests that OTR provide an anticipated completion date by November 22, 2010.

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## **FINDINGS AND RECOMMENDATIONS**

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### **FINDING 3: REPORTING OF LABOR DISTRIBUTION**

#### **SYNOPSIS**

The testing of the monthly labor distribution reports and summaries from January to June 2008, found inaccuracies and inconsistencies in the reporting which may have a significant impact on the Monthly Metrics Reports provided to CA and OTR management. We found: (1) all Audit Division staff did not report their monthly labor distribution; (2) use of multiple labor distribution reporting formats increased the opportunities for undetected errors; (3) validation of reported hours against the tours of duty were not performed; (4) the detailed and summary distribution reports were not verified for mathematical accuracy; and (5) the hours expended were not consistently coded on the detailed distributions and summaries. The absence of effective supervisory review and definitive guidance for reporting labor distributions permitted these conditions to exist. These conditions resulted in the Audit Division being unable to provide a reasonable assurance that its Monthly Metrics Reports relying on labor distribution data were accurate.

#### **DISCUSSION**

The accurate reporting of labor hours is essential to many management and reporting functions. It allows the Audit Division's management to determine the number of hours spent on examinations, audits, and other assignments. The labor distribution reporting supplements the time reported for payroll purposes, and provides more specific details on how time was expended. Table 5 provides additional detail of our review of the Audit Division's labor distribution reporting.



## FINDINGS AND RECOMMENDATIONS

**Table 5**  
**Summary of Estimated Available and Actual Hours Reported**

Month	Work Days <sup>a</sup>	Available Hours <sup>b</sup>	Reported Hours <sup>c</sup>	Difference between Available and Reported	Available Hours per Individual <sup>d</sup>	Average reported per Individual <sup>e, f</sup>	Difference Between Available and Reported per Individual <sup>f</sup>
January	23	12,696.00	12,340.70	355.30	184.00	178.85	5.15
February	21	11,592.00	11,340.00	252.00	168.00	164.35	3.65
March	21	11,592.00	11,117.00	475.00	168.00	161.12	6.88
April	22	12,144.00	11,773.50	370.50	176.00	170.63	5.37
May	22	12,144.00	11,034.50	1,109.50	176.00	159.92	16.08
June	21	11,592.00	10,583.00	1,009.00	168.00	153.38	14.62
<b>Total</b>	<b>130</b>	<b>71,760.00</b>	<b>68,188.70</b>	<b>3,571.30</b>	<b>1,040.00</b>	<b>988.25</b>	<b>51.75</b>

**Source:** Audit's Monthly Expended Time Reports for Staff and OIO analysis of the data.

- Notes:**
- <sup>a</sup> Work Days computed using calendar days per work week
  - <sup>b</sup> Work Days based on an 8 hour day for 69 employees within Audit.
  - <sup>c</sup> Total hours reported from timesheets and monthly summaries
  - <sup>d</sup> Work Days multiplied by 8 hours per day
  - <sup>e</sup> Total hours per month divided by 69 employees each month
  - <sup>f</sup> Detail may not agree with the total due to rounding

**a. All Audit Staff Did Not Complete Monthly Labor Distribution Reports.**

According to the Audit Division's staff interviewed by OIO, all staff was to report their time and attendance and the categories where time was expended during the month. These reports are used in part to produce the metrics reports prepared by the Audit Division for CA and OTR's senior management. Our review of the period January 1 through June 30, 2008 found that not all of the staff reported their labor distribution using the Audit Division's prescribed formats. We found that in at least one instance a team leader who held this position for the time period under review reported their labor distribution once during the six month period. Other Audit Division staff did not appear to consistently report their labor distribution. We did not find evidence that would support the team leaders or other audit staff following up with the staff to obtain the necessary reports. The absence of these reports results in an understatement of the hours actually worked by the staff on various assignments and impacts the accuracy of hours reported used to close various examinations and audits.

**b. Multiple Reporting Formats Increases the Opportunities for Undetected Errors.**

OIO noted that several different formats were used by individual Audit staff to report their monthly labor distribution. These formats included reports that accounted for daily and weekly hours that were rolled up to a detailed monthly report and then a monthly summary. Further, we noted several different reporting formats were used to capture labor distribution data and that the Audit Division's staff would include additional reporting lines when the activities they

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## FINDINGS AND RECOMMENDATIONS

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performed did not agree with the standardized reporting. These multiple formats increased the opportunities for errors and inaccurate reporting. Further, the multiple formats used by the Audit Division's staff did not assure that the reports captured all of the required data for use by management.

The Audit Division's staff appeared to be expected to account for their labor hours on a daily weekly and monthly basis and to report this data using several formats. The forms used by the Audit Division appeared to be a carryover from a manual reporting process. Some of the staff had developed a spreadsheet compatible version of the time reports in order to roll up the data. In some instances they had reduced the form to fit on an 8.5" by 11.0" sheet of paper by eliminating various time codes and lines of the original form. We noted inconsistencies in the reporting and the accumulation of data in several of the monthly reports. For example, (1) the detailed monthly reports did not agree with the summary report in the number of hours included in each report; (2) not all of the hourly categories appeared to be carried over to the monthly reports; and (3) the staff failed to report hours for holidays that were not worked; new categories for time reporting were entered into the time reports that did not always appear to be reflected in the summary data. Further, it appeared that the Audit Division's supervisors routinely approved the labor distribution reports without verifying their accuracy.

c. Validation of Hours Reported Against Tours of Duty

The Audit Division's team supervisors and senior managers did not validate the number of hours reported by individual staff against their stated tours of duty. We found disparities in the total hours reported by Audit Division's staff. These disparities impacted the accuracy of the reporting and did not assist in providing a reasonable assurance that an individual auditor has accounted for all hours in their tours of duty for the monthly period.

The Audit Division's supervisors explained to OIO that all hours of an individual's tour of duty should be accounted for in the individual's monthly time report. We found that this did not appear to be consistently occurring among the staff preparing the reports. Table 5 provides an estimation of the number of available hours and the hours actually reported for the period January 1, through June 30, 2008.

According to the Audit Division's staff that we interviewed, the individual team supervisors were to validate the hours worked and reported before the detailed timesheets and summaries were submitted. In OIO's opinion, this should include validating the hours reported against an individual's tour of duty. This step is necessary to ensure the accuracy of the reporting and to ensure that all of the employee's scheduled hours are reported. Further, it appeared that the Audit Division did not, at least on a sample basis, review the detailed and summary labor distribution reports submitted by the teams to validate the accuracy of the reporting and the supervisory review. This check validates the accuracy of the reporting and ensures that the supervisors are ensuring that all of the necessary data is captured. Our review of the detailed and monthly summaries found wide variations in the number of hours reported by individual auditors that did not appear to be addressed by the individual team supervisors.

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## FINDINGS AND RECOMMENDATIONS

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d. Detailed and Summary Labor Distribution Reports not Consistently Verified for Mathematical Accuracy

In addition to the differences in the number of hours reported, we identified computation errors in the calculation of the total hours for monthly reporting periods and differences between the monthly detailed reports and the summaries provided to the audit team supervisors. The supervisors routinely approved the detailed and summary information without verifying its mathematical accuracy. OIO's review of the labor distribution reports found differences from less than a single hour to multiple hours between the data reported in the detailed and summary forms. We found no evidence that would support the reports being returned to the auditor for validation and/or correction.

The Audit Division's staff relied on both the detailed and summary timesheets to perform various tasks. By not ensuring that the information is accurately summarized and transferred from detailed to the summary report, Audit compromises the validity of the data that it is reporting.

e. Hours were not Consistently Coded on the Detailed Timesheets

OIO's review of the detailed labor distribution reports found that the hours were not consistently coded. We found that individual auditors often entered additional lines to account for an activity. For example, one auditor consistently recorded time to cigarette tax stamp audits, however, none of the results appeared to be recorded in his summary of closed cases during the period. In other cases auditors would add a line to the detailed timesheet to account for a project or assignment that did not appear to be included in the report. This inconsistent coding impact the accuracy of the data drawn from various reports and any inferences made using the data. OIO is aware that it is not possible to provide for every situation, but minimizing the need for adding additional lines to the detailed and summary timesheets Audit helps to assure that labor distribution data is reported in a consistent manner.

OIO during our interviews found that information on completion of the detailed and summary time reports were passed on by word of mouth among the staff. This practice allows for wide interpretations of what each of the lines should include. This process can create disparities in reporting which limits the ability of the Audit Division and OTR management to draw valid comparisons of data from one period to another.

## RECOMMENDATIONS

The DCFO, OTR take the following actions to:

14. Revise the policies, procedures, and systems used to report Audit labor distribution and areas of effort. Supervisory review and certification should be mandated in the revised policies.

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## FINDINGS AND RECOMMENDATIONS

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15. Establish standard definitions of the activities that should be included in the standardized monthly time reports and the combinations of lines to combine in the monthly summaries. Consideration should be given to electronic spreadsheets that are protected except for cells where the employee enters their time distribution.
16. Require all Audit staff report their labor distribution on a monthly basis.
17. Perform a periodic independent review a selection of the labor distribution reports for accuracy, consistency, and reasonableness.

### MANAGEMENT RESPONSE AND OIO COMMENTS

#### Management Response (Recommendations 14 through 17)

OTR agreed with the recommendation and stated that starting in FY-11 the Audit Division will collect the labor distribution hours and the time spent on individual cases. The development of forms, policies, and procedures to address the reporting, collection and supervisory approval are on-going. Employees will be required to account for the actual hours worked in addition to various administrative functions.

#### OIO COMMENTS

We consider OTR's planned actions to be responsive to the intent of the recommendation OTR did not provide an anticipated date for the completion of the policies, procedures, and practices. OIO requests that OTR provide an anticipated completion date by November 22, 2010.

## EXHIBIT A: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

Recommendation	Description of Benefit	Type of Benefit	Agency Reported Estimated Completion Date	Status <sup>13</sup>
1	Ensures that high risk returns types are identified for potential examinations and audits.	Internal Control and Efficiency	Sep. 30, 2011	Open
2	Provides for the development of an annual audit plan that targets high risk return types and employs all of Audit's resources.	Economy and Efficiency	To Be Determined (TBD)	Open
3	Provides for the development of an annual audit plan and periodic updates	Efficiency	Sep. 30, 2011	Open
4	Provides for monthly metrics reporting that reflects the annual audit plan.	Efficiency	Dec. 31, 2010	Open
5	Provides for more efficient targeting of tax returns for examination and audit	Economy and Efficiency	TBD	Open
6	Provides for more effective use identification of tax returns for examination and audit.	Potential Monetary \$8,300,000	TBD	Open
7	Ensures that examinations and audit meet professional independence standards and staff complies with Code of Conduct and independence standards	Internal Control and Effectiveness	TBD	Open
8	Provides for standardized examinations and audits and assists in compliance with professional standards.	Internal Control and Effectiveness	TBD	Open

<sup>13</sup> This column provides the status of a recommendation as of the report date. For final reports, “Open” means management and the OIO are in agreement on the action to be taken, but action is not complete. “Closed” means management has advised that the action necessary to correct the deficiency is complete. If a completion date was not provided, the date of management’s response is used. “Unresolved” means that management has neither agreed to take the recommended action nor proposed a satisfactory alternative action to correct the condition.

## EXHIBIT A: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

<b>Recommendation</b>	<b>Description of Benefit</b>	<b>Amount and Type of Benefit</b>	<b>Agency Reported Estimated Completion Date</b>	<b>Status</b>
9	Mandates and documents compliance with OCFO Code of Conduct and professional standards.	Compliance	TBD	Open
10	Provides for standardized workpapers, indexing and audit documentation.	Economy and Efficiency	September 2010	Closed
11	Provides a quality control system to ensure continued compliance with professional standards.	Internal Control	September 2010	Closed
12	Provides for quality control reviews and staff training based on the reviews' results.	Internal Control, Economy and Efficiency	TBD	Open
13	Safeguards agency records using the same standards as those for IRS supplied data	Compliance	TBD	Open
14	Provides policies and procedures to assist in the accurate capture of labor distribution.	Internal Control and Compliance	TBD	Open
15	Provides standardized reporting for labor distribution	Economy and Efficiency	TBD	Open
16	Provides for timely reporting by all Audit staff.	Compliance	TBD	Open
17	Provides validation of Audit staff labor distribution.	Compliance	TBD	Open

## EXHIBIT B: TABLES SUPPORTING AUDIT FINDINGS AND RECOMMENDATIONS

**TABLE B-1**  
**Examinations, Audits, Assessments by Type - FY-06**

Types of Returns Examined/Audited	Returns Audited	Percentage	Total Assessments	Percentage of Total Assessments <sup>1</sup>
Individual Income (includes joint returns)	1,486	48.39	951,059	2.75
Corporate Business Franchise	141	4.59	7,509,740	21.73
Unincorporated Business Franchise	59	1.92	4,517,249	13.07
Fiduciary Taxes	6	0.20	17,959	0.06
Employee Withholding	8	0.26	349,371	1.01
Sales and Use	336	10.94	14,561,043	42.14
Excise Tax	14	0.46	525,078	1.52
Inheritance and Estate Taxes	21	0.68	662,845	1.92
Personal Property	64	2.08	2,366,862	6.85
Federal Adjustments	936	30.48	3,092,149	8.95
CP-2000	-0-	0.00	-0-	0.00
Multistate Tax	-0-	0.00	-0-	0.00
Hotel Occupancy	-0-	0.00	-0-	0.00
<b>Total for Fiscal Year</b>	<b>3,071</b>	<b>100.00</b>	<b>34,553,355</b>	<b>100.00</b>

Source: Monthly Metrics Report Supplied by Audit

<sup>1</sup> May not total to 100.00 due to rounding

**TABLE B-2**  
**Examinations, Audits, Assessments by Type - FY-07**

Types of Returns Examined/Audited	Returns Audited	Percentage of Returns Audited <sup>1</sup>	Total Assessments through Audit	Percentage of Total Assessments <sup>1</sup>
Individual Income (includes joint returns)	1,602	36.78	24,047,869	31.00
Corporate Business Franchise	192	4.41	10,843,605	13.98
Unincorporated Business Franchise	84	1.93	2,107,469	2.72
Fiduciary Taxes	1	0.02	593	0.00
Employee Withholding	10	0.23	10,130	0.01
Sales and Use	337	7.74	15,410,440	19.87
Excise Tax	119	2.73	8,227,445	10.61
Inheritance and Estate Taxes	32	0.73	6,980,718	9.00
Personal Property	249	5.72	2,196,032	2.83
Federal Adjustments	1,729	39.69	7,062,462	9.10
CP-2000	0	0.00	0	0.00
Multistate Tax	1	0.02	684,870	0.88
Hotel Occupancy	0	0.00	0	0.00
<b>Total for Fiscal Year</b>	<b>4,356</b>	<b>100.00</b>	<b>77,571,633</b>	<b>100.00</b>

Source: Monthly Metrics Report Supplied by Audit

<sup>1</sup> May not total to 100.00 due to rounding

## EXHIBIT B: TABLES SUPPORTING AUDIT FINDINGS AND RECOMMENDATIONS

**TABLE B-3**  
**Examinations, Audits, Assessments by Type – FY-08**

Types of Returns Examined/Audited	Returns Audited	Percentage of Returns Audited <sup>1</sup>	Total Assessments through Audit	Percentage of Total Assessments <sup>1</sup>
Individual Income (includes joint returns)	2,653	36.70	20,603,722	28.95
Corporate Business Franchise	401	5.55	10,541,909	14.81
Unincorporated Business Franchise	107	1.48	1,795,132	2.52
Fiduciary Taxes	10	0.14	321,505	0.45
Employee Withholding	81	1.12	71,787	0.10
Sales and Use	445	6.16	22,742,786	31.96
Excise Tax	267	3.69	4,591,363	6.45
Inheritance and Estate Taxes	45	0.62	223,340	0.31
Personal Property	238	3.29	2,498,045	3.51
Federal Adjustments	2,981	41.24	7,283,502	10.24
CP-2000	0	0.00	0	0.00
Multistate Tax	1	0.01	484,935	0.68
Hotel Occupancy	0	0.00	0	0.00
<b>Total for Fiscal Year</b>	<b>7,229</b>	<b>100.00</b>	<b>71,158,026</b>	<b>100.00</b>

Source: Monthly Metrics Report Supplied by Audit

<sup>1</sup> May not total to 100.00 due to rounding

**TABLE B-4**  
**Examinations, Audits, Assessments by Type – FY-09 (May 31, 2009)**

Types of Returns Audited	Returns Audited	Percentage of Returns Audited <sup>1</sup>	Total Assessments through Audit	Percentage of Total Assessments <sup>1</sup>
Individual Income (includes joint returns)	1,818	32.82	1,278,805	3.41
Corporate Business Franchise	293	5.29	9,843,283	26.27
Unincorporated Business Franchise	79	1.43	973,949	2.60
Fiduciary Taxes	2	0.04	5,608	0.01
Employee Withholding	42	0.76	62,132	0.17
Sales and Use	286	5.16	12,252,821	32.70
Excise Tax	1,094	19.75	7,837,634	20.92
Inheritance and Estate Taxes	51	0.92	30,394	0.08
Personal Property	108	1.95	1,056,520	2.82
Federal Adjustments	1,766	31.88	4,071,191	10.87
CP-2000	0	0.00	0	0.00
Multistate Tax	0	0.00	52,451	0.14
Hotel Occupancy	0	0.00	0	0.00
<b>Total for Fiscal Year</b>	<b>5,539</b>	<b>100.00</b>	<b>37,464,788</b>	<b>100.00</b>

Source: Monthly Metrics Report Supplied by Audit

<sup>1</sup> May not total to 100.00 due to rounding



## EXHIBIT B: TABLES SUPPORTING AUDIT FINDINGS AND RECOMMENDATIONS

**Table B-5**  
**Change in Closed Cases and Assessments FY-06 through FY-09**

	<b>FY-06</b>	<b>FY-07</b>	<b>FY-08</b>	<b>FY-09 (May 31)</b>	<b>FY-09 Actual</b>
Examinations and Audits Closed	3,071	4,356	7,229	5,539	8,083
Numerical Change from Prior Fiscal Year	NA <sup>1</sup>	1,285	2,873	(1,690)	854
Percentage Change from Prior Fiscal Year	NA <sup>1</sup>	41.84	65.96	(23.38)	11.81
Additional Assessments	\$34,553,355	\$77,571,633	\$71,158,026	\$37,464,788	\$65,827,545
Average Assessment per Closed Examination or Audit	11,251	17,807	9,843	6,764	8,144
Change in Total Assessments from Prior Year	NA <sup>1</sup>	43,018,278	(6,413,607)	(33,693,238)	(5,330,481)
Change in Average Assessment from Prior Year	NA <sup>1</sup>	6,556	(7,964)	(3,079)	(1,699)
Percentage Change from Prior Year	NA <sup>1</sup>	58.27	(44.73)	(31.28)	(17.26)

**Source:** Audit's Monthly Metrics Reports

<sup>1</sup> N/A is Not Available

**Table B-6**  
**Systems that Account for Tax Returns**

<b>Tax Type</b>	<b>System Used to Account for Tax Return</b>	
	<b>ITS</b>	<b>non-ITS</b>
Individual Income	X	
Annual Fiduciary Tax Returns	X	
Sales and Use Taxes	X	
Inheritance and Estate Tax Returns		X
Corporation Franchise	X	
Unincorporated Franchise Taxes	X	
Gross Receipts Taxes		X
Partnership Taxes		X
Employee Withholding Taxes	X	
Personal Property Taxes	X	
Hotel Occupancy Tax		
Wholesalers Alcoholic Beverage Tax		X
Cigarette Tax		X
Motor Fuel Tax	X	
Toll Telecommunication Service		X
Commercial Mobile Service Tax		X
<b>Total Tax Types Accounted for in Each System</b>	<b>8</b>	<b>7</b>

**Source:** Audit

## EXHIBIT B: TABLES SUPPORTING AUDIT FINDINGS AND RECOMMENDATIONS

**Table B-7**  
**EQMS Audit Standards Summary**

No.	Standard	Key Elements	Purpose
1	Considered large, unusual, or questionable items	A. Balance Sheet and Schedule M considered. B. Income deduction and credit items considered C. Scope of the examination was appropriate	Measures whether consideration was given to large, unusual, questionable items in both the precontact stage and during the course of the examination.
2	Probes for unreported income	A. Consideration of internal controls for all business returns. B. Consideration of books and records. C. Consideration of financial status D. Appropriate use of indirect methods.	Measures whether the steps taken verified that the proper amount of income was reported.
3	Required filing checks	A. Consideration of prior and subsequent year's tax returns. B. Consideration of related returns. C. Compliance items considered	Measures whether consideration was given to filing and examination potential of all returns required by the taxpayer including those entities in the sphere of influence/responsibility.
4	Examination of the depth of records examined.	A. Adequate interviews conducted B. Adequate exam techniques used C. Fraud adequately considered and developed. D. Issues sufficiently developed	Measures whether the issues examined were complete to the extent necessary to determine substantially correct tax.
5	Findings supported by law	A. Correct technical/factual conclusions reached	Measures whether the conclusions reached were based on a correct application of tax law.
6	Penalties properly considered	A. Recognized, considered, and correctly applied. B. Penalties computed correctly	Measures whether the applicable penalties were considered and applied correctly.
7	Workpapers support conclusions	A. Fully disclose audit trail and techniques. B. Legible and organized C. Adjustments in the workpapers agree with Forms 4138, 4700, and reports D. Activity record adequately documents exam activities E. Disclosure	Measures the documentation of the examination's audit trail and techniques used.

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## EXHIBIT B: TABLES SUPPORTING AUDIT FINDINGS AND RECOMMENDATIONS

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No.	Standard	Key Elements	Purpose
8	Report writing procedures followed	A. Applicable report writing procedures followed B. Correct tax computation	Measures the presentation of the audit findings in terms of content, format, and accuracy
9	Time span/time charged	A. Examination time commensurate B. Exam initiation C. Examination activities D. Case closing	Measures the utilization of time as it relates to the complete audit process.

**Source:** GAO Report; *IRS AUDITS: Workpapers Lack Documentation of Supervisory Review*; Report Number: GAO/GGD 98-98, April 1998, pages 12 – 13.

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## EXHIBIT C: ABSTRACTS FROM RELEVANT PORTIONS OF THE PROFESSIONAL AUDIT STANDARDS

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### Exhibit C-1

#### *IA Standards, Planning, Section 2100*

##### **§ 2010.A1**

*The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process."*

A practice advisory for the *IA Standards* titled *Linking the Audit Plan to Risk and Exposures* discusses the need to update audit plans by stating:

*"4. The audit universe and related audit plan are updated to reflect changes in management direction, objectives, and emphasis, and focus. It is advisable to assess the audit universe on at least an annual basis to reflect the most current strategies and direction of the organization. In some situations, audit plans may need to be updated more frequently (e.g. quarterly) in response to changes in the organization's business operations, programs, systems and controls."*

**Source:** <http://www.theiia.org/guidance/standards-and-guidance/ippf/standards/standards-items/?C=3094&i=8259>

### Exhibit C-2

#### **GAGAS Definition of an Attestation Engagement**

**1.23** *"Attestation engagements can cover a broad range of financial or nonfinancial objectives and may provide different levels of assurance about the subject matter or assertion depending on the users needs. Attestation engagements result in an examination, a review, or an agreed-upon procedures report on a subject matter or an assertion about a subject matter that is responsibility of another party. The three types of attestation engagements are:*

- a. Examination: Consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter is based on (or in conformity with) the criteria in all material respects or the assertion is presented (or fairly stated), in all material respects, based on the criteria.*
- b. Review: Consists of sufficient testing to express a conclusion about whether any information came to the auditors' attention on the basis of the work performed that indicates the subject matter is not based on (or in conformity with) the criteria or the assertion is not presented (or fairly stated) in all material respects based on the criteria. As stated in the AICPA SSAE, auditors should not perform review-level work for reporting on internal controls or compliance with laws and regulations.*
- c. Agreed-Upon Procedures: Consists of specific procedures performed on a subject matter.*

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## EXHIBIT C: ABSTRACTS FROM RELEVANT PORTIONS OF THE PROFESSIONAL AUDIT STANDARDS

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*1.24 The subject matter of an attestation engagement may take many forms. Possible subjects of attestation engagements include reporting on: ...*

- e. an entity's compliance with requirements of specified laws, regulations, policies, contracts, or grants."*

**Source:** Comptroller General of the United States; Government Accountability Office, *Government Audit Standards – 2007 Revision*; Report Number GAO-07-731G, July 2007; pages 15 – 16 found at <http://www.gao.gov/new.items/d07731g.pdf>

### Exhibit C-3 GAAS Definition of an Attestation Engagement

Attest Engagements § AT 101

*.01 This section applies to engagements, except for those services discussed in paragraph .04 in which a certified public accountant in the practice of public accounting<sup>1</sup> (hereinafter referred to as practitioner) is engaged to issue or does issue an examination, a review, or agreed upon procedures report on subject matter, or an assertion about the subject matter (hereinafter referred to as the assertion), that is the responsibility of another party.*

*.03 When a practitioner undertakes an attest engagement for the benefit of a government body or agency and agrees to follow specified government standards, guides, procedures, statutes, rules, and regulations, the practitioner is obliged to follow those governmental requirements as well as the applicable attestation standards.*

*.06 Any professional service resulting in the expression of assurance must be performed under AICPA professional standards that provide for the expression of assurance...*

**Source:** American Institute of Certified Public Accountants; *Professional Standards as of June 1, 2008*; *Attest Engagements*; section AT 101 located at <http://www.aicpa.org/download/members/div/auditstd/AT-00101.PDF>; the footnotes contained in abstracted portion of the standard were not copied.

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## EXHIBIT C: ABSTRACTS FROM RELEVANT PORTIONS OF THE PROFESSIONAL AUDIT STANDARDS

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**Table C-4**  
**Title 17 District of Columbia Municipal Regulations section 2511**  
**Code of Professional Conduct: Competence and Technical Standards**

- 2511.1 A licensee shall not undertake any engagement for the performance of professional services that he or she cannot reasonably expect to complete with due professional competence, including compliance, where applicable, with the requirements of this section.
- 2511.2 A licensee shall not permit his or her name to be associated with financial statements in a manner that implies that the licensee is acting as an independent public accountant with respect to those financial statements unless the licensee has complied with applicable generally accepted auditing standards.
- 2511.3 The Board considers statements on auditing standards issued by the American Institute of Certified Public Accountants and other pronouncements having similar generally recognized authority to be interpretations of generally accepted auditing standards. Departures from these statements shall be justified by anyone who does not follow them.
- 2511.4 A licensee shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if the financial statements contain any departure from generally accepted accounting principles that has a material effect on the financial statements taken as a whole, except as provided in § 2511.5.
- 2511.5 A licensee may express an opinion that financial statements are presented in conformity with generally accepted accounting principles when the financial statements contain a departure from generally accepted accounting principles that has a material effect on the financial statements taken as a whole if the licensee can demonstrate that, by reason of unusual circumstances, the financial statements would otherwise have been misleading.
- 2511.6 When there is a departure from generally accepted accounting principles, the licensee's report shall describe the departure, the approximate effects thereof, if possible, and the reasons why compliance with generally accepted accounting principles would result in a misleading statement.
- 2511.7 For purposes of this chapter, generally accepted accounting principles are those principles defined by pronouncements issued by the Financial Accounting Standards Board and its predecessor and similar pronouncements issued by other Board approved entities having similar, generally recognized authority.
- 2511.8 In the performance of other accounting services, a licensee shall comply with all professional and technical standards generally recognized by the profession for the particular service. 2511.9 A licensee, in the performance of professional services, shall not permit the use of his or her name in conjunction with any forecast of future transactions in a manner that may reasonably lead to the belief that the licensee vouches for the achievability of the forecast.

SOURCE: Final Rulemaking published at 51 DCR 4401 (April 30, 2004).

*(Emphasis Added)*

Source: <http://www.dcregs.dc.gov/Gateway/RuleHome.aspx?RuleNumber=17-2511>

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## EXHIBIT D: OFFICE OF TAX AND REVENUE'S RESPONSE

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GOVERNMENT OF THE DISTRICT OF COLUMBIA  
Office of the Chief Financial Officer  
Office of Tax and Revenue



Stephen M. Cordi  
Deputy Chief Financial Officer

### MEMORANDUM

**TO:** William J. DiVello, Executive Director  
Office of Integrity and Oversight

**FROM:** Stephen M. Cordi, Deputy Chief Financial Officer  
Office of Tax and Revenue

**DATE:** September 30, 2013

**SUBJECT:** Response to Draft Report: Audit of the Office of Tax and Revenue Audit  
Division's Process for Selecting Tax Returns for Examination and Audit  
(Report No. OIO: 10-1-02-OTR)

Attached is our response to the draft report regarding the Office of Tax and Revenue Audit Division's Process for Selecting Tax Returns for Examination and Audit (Report No. OIO-10-1-02-OTR).

Our written response includes suggested actions taken, planned, target dates for completion, reasons for disagreement and proposed alternatives to correct noted deficiencies.

If you have any questions, please contact Bedell Terry, Director, Compliance Administration, at 202-442-6863.

Attachment

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## EXHIBIT D: OFFICE OF TAX AND REVENUE'S RESPONSE

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### Audit Division

#### *Audit of the Office of Tax and Revenue*

#### *Audit Division's Process for Selecting Tax Returns for Examination and Audit*

#### List of Recommendations Contained in the Report

1. **Develop annual risk assessments and methodologies for all non real property tax returns that incorporate the prior year audit results and significant changes in the statutes and regulations.**

We agree with the recommendation.

The Audit Division is in the process of developing a return classification program. The program will take prior year information and new legislation and other factors into a blueprint for the selection of returns for audit. The program components will be completed by 3/31/11. Return selection under the new criteria should be implemented by 9/30/11.

2. **Incorporate the IA Standards for Planning, or similar guidance into the annual planning process.**

We agree with the meaning of this recommendation.

The Compliance Administration has developed a work plan to review the 14 tax types. We do not conduct CP-2000 and Hotel Occupancy audits. The employees in Compliance do not conduct audits as defined in the IA Standards for Planning. We will secure the IRS standards and guidelines for planning tax audits and implement them in the Audit Division. The purpose of the Audit Division is to conduct examination of tax returns for adherence to the tax laws and regulations. We are also looking at changing the series to Revenue Agent as opposed to Tax Auditor.

3. **Develop an annual risk based audit plan that incorporates estimates of staff availability and risk assessments.**

We agree with this recommendation.

Return Classification and Audit Work plan will accomplish this recommendation.

4. **Revise the monthly Metrics Report to include all tax return types and reflect the data in the annual plan.**

We agree with this recommendation.

We will update the Metrics Report to include all tax return types except CP-2000 and Hotel Occupancy (HO). CP-2000 is currently being worked in Collection and Hotel Occupancy is not part of the work plan. These actions will be completed by 12/31/10.



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5. **Modify the TIS selection process to increase the sensitivity to the items selected and the score that must be obtained for selection as a potential examination or audit.**

We agree with this recommendation.

The Classification process will establish a pool cases that will be used to supply managers with cases for examination. The pool will be maintained by Review and Conference (R&C). A manager will keep a limited inventory and will be able to request additional cases as needed. They will assign cases to employees that will take some of the risk from this process. We agree to prepare a SCR. Implementation of the SCR will be the responsibility of the Tax Systems Group.

6. **Use experienced auditors to screen returns selected for examination and audit prior to assignment to another auditor decreasing the number of "no change returns" and increasing the audit quality of the returns and the potential additional tax assessments. The reason for rejection of any selected returns should be documented.**

We agree with this recommendation.

Senior Tax Auditors will participate in the classification group on a rotational basis. They will designate cases for audit. Group managers will request cases for assignment to Tax Auditors. This will eliminate the self assignment.

7. **Revise the process for review and assignment of taxpayer and return referrals to ensure independence in the referral/audit process. For example requiring all the auditors involved in the planning, execution, or review of the audit to sign an independence statement. The independence statement includes both the *Code of Conduct* and GAGAS requirements.**

We agree with the recommendation to revise the case assignment process. We disagree with the recommendation to require auditors to sign an independence statement.

As stated in other recommendation the Compliance Administration is establishing a return classification program. Since auditors will be assigned cases from a common pool by the manager there will be little or no need for an independence statement. The Code of Conduct is sufficient.

8. **Direct the development of GAGAS compliant and comprehensive policies, procedures, and practices for conducting examinations and audits.**

We agree with the recommendation to develop comprehensive policies, procedures and practices for conducting examinations. We disagree with the requirement to become GAGAS compliant.

The GAGAS compliance requirement is a requirement for auditors not for the examination of tax returns.

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## EXHIBIT D: OFFICE OF TAX AND REVENUE'S RESPONSE

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- 9. Mandate documented compliance with the independence standards of the GAGAS and the Code of Conduct. For example, requiring auditors to sign an independence statement.**

Please see recommendation #8.

- 10. Direct specific procedures for the preparation of workpapers, indexing, and audit documentation.**

We agree with this recommendation. It has been implemented.

Standard work papers and audit documentation was issued to employees in January 2010. The information is housed on the Intranet at [http://www.efo.in.de.gov/efo/frames.asp?doc=/efo/lib/efo/intranet/\\_standard\\_layout\\_for\\_workpapers.pdf](http://www.efo.in.de.gov/efo/frames.asp?doc=/efo/lib/efo/intranet/_standard_layout_for_workpapers.pdf)

- 11. Mandate that R&C and Audit Division management develop a documented quality control system for all examinations and audits.**

We agree with this recommendation.

The Audit Division implemented a post review process during FY2010. The Review and Conference group reviews closed cases to identify trends and patterns for training purposes. Policies and procedures have been developed.

- 12. Direct that R&C, based on the results of quality control reviews, provide training on a group and individual level. Training should include the Audit Division's policies and procedures, audit standards, preparation of workpapers, audit evidence, preparation of audit reports, and quality control standards.**

We agree with the recommendation to use quality review results to develop and provide training.

The Compliance Administration will determine who conducts the training.

- 13. Develop a policy and system for retention of all examination and audit reports, workpapers, documentation and files in a centralized location.**

We agree with this recommendation.

The Compliance Administration does not have physical space for the retention of the actual hard copy documents referred to in the recommendation. Therefore we have ordered eight 1TB hard drives so that documents can be scanned and retained in a digital format.

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## **EXHIBIT D: OFFICE OF TAX AND REVENUE'S RESPONSE**

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- 14. Revise the policies, procedures, and systems used to report Audit labor distribution and areas of effort. Supervisory review and certification should be mandated in the revised policies.**

We agree with this recommendation.

A form has been developed in Audit for use in FY 2011 that will collect the distribution of labor and case work times. The policies and procedures being developed will require managers to review return and certify time sheets. Employees will be required to account for actual hours worked on cases, leave and administrative functions. This will include requirements for 14, 15, 16, & 17.

- 15. Establish standard definitions of the activities that should be included in the standardized monthly time reports and the combinations of lines to combine in the monthly summaries. Consideration should be given to electronic spreadsheets that are protected except for cells where the employee enters their time distribution.**
- 16. Require all Audit staff to report their labor distribution on a monthly basis.**
- 17. Perform a periodic independent review a selection of the labor distribution reports for accuracy, consistency, and reasonableness.**